

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:SCA:SD:TL-N-5963-99

GAKindel

date: **SEP 30 1999**

to: Examination Division, Southern California District
ATTN: Rick Woods, CE1108

from: Associate District Counsel, Southern California District, San Diego

subject: [REDACTED] - Dividend Received Deduction under I.R.C. § 243

This memorandum responds to your request for advice regarding the effect of an option to sell preferred stock that was held by [REDACTED] (the "Taxpayer") on the Taxpayer's entitlement to a dividends received deduction under I.R.C. § 243 with respect to dividends received on such preferred stock.

DISCLOSURE LIMITATIONS

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUE

Whether the Taxpayer is entitled to a deduction equal to 70 percent of the amount received as dividends from [REDACTED] during the fiscal years ended [REDACTED] through [REDACTED] where:

- a. the Taxpayer owns all of the outstanding non-voting preferred stock of [REDACTED];
- b. [REDACTED], an unrelated party, owns all of the outstanding voting common stock; and
- c. the Taxpayer owns an option to require [REDACTED] at any time, to purchase all of its shares of preferred stock for \$[REDACTED].

CONCLUSION

Yes. The Taxpayer received shares of Series A Preferred Stock in [REDACTED] in exchange for a portion of its shares of [REDACTED] common stock. By virtue of I.R.C. § 1223, the holding period for the Series A Preferred Stock includes the period during which the Taxpayer held the shares of [REDACTED] common stock. It is clear that the Taxpayer held the shares of [REDACTED] common stock exchanged for longer than 45 days. Because the Taxpayer held the shares for longer than 45 days, it is not prohibited by I.R.C. § 246(c) from deducting 70 percent of the amount received as dividends from [REDACTED].

FACTS

I. PLAYERS

[REDACTED] (the "Taxpayer") is a Delaware corporation engaged primarily as a government defense contractor. The Taxpayer and its subsidiaries file consolidated income tax returns on a fiscal year ending [REDACTED] basis.

[REDACTED] is a California corporation incorporated in [REDACTED]. Prior to [REDACTED], [REDACTED] was a wholly owned subsidiary of the Taxpayer. The total authorized number of shares of common stock is [REDACTED]. Prior to [REDACTED], [REDACTED] had only [REDACTED] shares of common stock issued and outstanding.

[REDACTED] is a Delaware corporation wholly owned by [REDACTED], a German Corporation. Neither [REDACTED] nor [REDACTED] is related to the Taxpayer or its affiliates.

II. TRANSACTION

On [REDACTED] the Taxpayer and [REDACTED] executed a Stock Purchase Agreement (the "Agreement") in which the Taxpayer agreed to sell all of the issued and outstanding common stock of [REDACTED] to [REDACTED]. As part of the Agreement, on [REDACTED] the Taxpayer exchanged [REDACTED] of its [REDACTED] shares of the common stock in [REDACTED] for [REDACTED] shares of newly authorized and newly issued Series A Preferred Stock of [REDACTED]. The Taxpayer then sold the remaining shares of common stock to [REDACTED] for \$ [REDACTED].

The holders of the outstanding Series A Preferred Stock are entitled to receive in each fiscal year, when as declared by the Board of Directors, dividends in cash at the rate of \$ [REDACTED] per share before any dividend is paid on the common stock. See Certification of Determination of Preferences of Preferred Stock of [REDACTED], \$ [REDACTED]. The right to such dividend is cumulative and shall accrue at the rate of \$ [REDACTED] per share whether or not dividends are declared or earned. Id. In the event of a liquidation, the holders of the outstanding Series A Preferred Stock are entitled to receive an amount equal to \$ [REDACTED] per share and a further amount equal to any dividends declared and unpaid on the date of the liquidation. Id. at \$ [REDACTED].

The Series A Preferred Stock is subject to redemption in whole or in part at any time at the option of the Board of Directors or at the option of the holder. Id. at \$ [REDACTED]. The Series A Preferred Stock has no voting rights. Id. at \$ [REDACTED].

Pursuant to the Agreement, the Taxpayer had the option, at any time after the closing, to require [REDACTED] to purchase all of the Series A Preferred Stock for \$ [REDACTED] plus accrued but unpaid dividends. See Stock Purchase Agreement, \$ [REDACTED].

It is unclear when the sale of [REDACTED] common stock to [REDACTED] closed.

The Taxpayer received dividends in the amount of \$ [REDACTED] in each of the fiscal years ending September 30, [REDACTED], [REDACTED], and [REDACTED] and claimed a deduction equal to 70 percent of these amounts on its federal income tax returns. In [REDACTED], the Taxpayer exercised its option to sell its Series A Preferred Stock to [REDACTED] for \$ [REDACTED].

DISCUSSION

I.R.C. § 243(a)(1) allows a corporation a deduction equal to 70 percent of the amount received as dividends from a domestic corporation which is subject to tax under the Internal Revenue Code.¹ I.R.C. § 246, however, places some limitations on the amount of the deduction allowable under I.R.C. § 243(a).

Under I.R.C. § 246(b), the aggregate amount of the deductions allowed by I.R.C. §§ 243(a)(1), 244(a), 245(a), and 245(b) may not exceed the percentage determined under I.R.C. § 246(b)(3) of the corporation's taxable income computed without regard to (1) the deductions allowed by I.R.C. §§ 172, 243(a)(1), 244(a), 245(a), and 245(b), (2) any adjustment made under I.R.C. § 1059, and (3) any capital loss carryback to the taxable year under I.R.C. § 1212(a)(1). For dividends received from "20-percent owned corporations" (as defined in I.R.C. § 243(c)(2)), the percentage is 80 percent. I.R.C. § 246(b)(3)(A). For dividends not received from 20-percent owned corporations, the percentage is 70 percent, and the taxable income against which the percent is applied is reduced by the aggregate amount of dividends received from 20-percent owned corporations. I.R.C. § 246(b)(3)(B).

We do not have sufficient information in this case to determine whether the deduction claimed by the Taxpayer is limited by I.R.C. § 246(b).

Under I.R.C. § 246(c), a taxpayer is not entitled to the deduction under I.R.C. § 243 with respect to a dividend received on any share of stock (1) which is held by it for 45 days or less during the 90-day period beginning on the date which is 45 days before the date on which such share becomes ex-dividend with respect to such dividend or (2) to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property. The holding period described above is reduced for any period in which the taxpayer has an option to sell, is under a contractual obligation to sell, or has made (and not closed) a short sale of, substantially

¹ I.R.C. § 243 also allows a corporation a deduction equal to 100 percent of the amount received as dividends from affiliated corporations (as defined in I.R.C. § 1504(a) and a deduction equal to 80 percent of the amount received as dividends from a "20-percent owned corporation" (as defined in I.R.C. § 243(c)). See I.R.C. §§ 243(a)(2) and 243(c). Neither of these provisions apply to the facts in this case.

identical stock. I.R.C. § 246(c)(4). Or stated differently, the holding period is tolled during the period the taxpayer has an option to sell, is under a contractual obligation to sell, or has made (and not closed) a short sale of, substantially identical stock.

As of [REDACTED], the Taxpayer owned [REDACTED] shares of newly issued Series A Preferred Stock in [REDACTED]. At all times after the closing of the sale of [REDACTED] common stock to [REDACTED] the Taxpayer had an option to sell the preferred shares to [REDACTED] for \$ [REDACTED]. The Service argues, therefore, that, because the Taxpayer held an option to sell the same stock that it owned virtually at all times that it owned the stock, it is not entitled to the dividends received deduction under I.R.C. § 243.² I.R.C. § 246(c); The Progressive Corp. and Subsidiaries v. United States, 970 F.2d 188, 193 (6th Cir. 1992).

The Service, however, has not properly determined the period in which the Taxpayer held the Series A Preferred Stock. The Taxpayer received [REDACTED] shares of Series A Preferred Stock in exchange for [REDACTED] shares of common stock in [REDACTED]. Because this transaction constituted a recapitalization under I.R.C. § 368(a)(1)(E), the Taxpayer did not recognize any gain or loss on the exchange. See I.R.C. §§ 368(a)(1)(E) and 354; see also Rev. Rul. 77-479, 1977-2 C.B. 119. And the Taxpayer's basis in the Series A Preferred Stock was the same as its basis in the shares of [REDACTED] common stock exchanged. I.R.C. § 358.

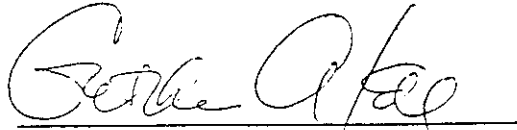
As a result, under I.R.C. § 1223, the holding period for the Series A Preferred Stock included the period for which the Taxpayer held the shares of [REDACTED] common stock exchanged. It is clear that the Taxpayer held its shares of [REDACTED] common stock for more than 45 days. The limitations of I.R.C. § 246(c), therefore, are not applicable to this case, and the Taxpayer is entitled to the dividends received deduction under I.R.C. § 243 for the amounts received from [REDACTED] as dividends on the Series A Preferred Stock.

² The Service may only make this argument if the closing date for the sale of [REDACTED] fell on or before [REDACTED] i.e., the date 45 days after the acquisition of the Series A Preferred Stock. It is unclear from the facts when the sale of [REDACTED] closed.

If you have any questions, please call the undersigned at
(619) 557-6014.

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Assistant District Counsel

By:

A handwritten signature in cursive script, appearing to read "Gretchen A. Kinde", written over a horizontal line.

GRETCHEN A. KINDEL
Attorney